

**STRENGTHENING THE FINANCIAL SECTOR**

**FOR AN**

**ACCELERATED PRIVATE SECTOR GROWTH:**

**THE RELEVANCE OF A CREDIT REPORTING  
SYSTEM**

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## **1. Introduction**

A Credit Reporting System is basically a system that collects, processes and collates credit information (both good and bad) from credit providers (financial institutions, utility providers, trade credit firms etc) and provides such information as and when needed, in the form of credit rating or scoring to a lender on a prospective borrower.

Credit Referencing Agencies also provide other value added services to their clients mostly credit providers such as scoring to enable them accurately predict levels of risk, debt collection, debt restructuring and management, asset registry, account management and other related services.

The legal framework that facilitates the establishment of a Credit Reporting System is the Credit Reporting Bill. Ghana's Credit Reporting Bill 2006 has been approved by Cabinet after 38 amendments and is due for consideration and passage when Parliament resumes in October.

Basically the law addresses issues such as licensing, operation and supervision of credit bureaus. It also seeks to establish conditions for the formation, processing, storage and disclosure of credit information. The Law when passed will mandate Bank of Ghana to regulate, license and supervise credit bureaus that would be established once the law becomes effective. This is to ensure that the required level of safety, soundness and integrity maintained by Bank of Ghana in the financial sector is brought to bear in this new industry. Credit bureaus would be required to meet minimum capital requirements before being licensed, and their licenses would be renewable on annual basis after meeting stipulated requirements by Bank of Ghana. Credit Bureaus once formed would be required to form an Association with a well outlined code of conduct. Due to the confidential nature of the data credit bureaus would be keeping, they would be required to meet disclosure standards commensurate to international best practices. The tenets of the law ensures safety, soundness, integrity and transparency in the regulation and supervision of credit bureaus thereby strengthening the financial sector markets and risk profiling in terms of credit delivery and management in Ghana.

## **2. Its Role in accelerating private sector growth**

The role a credit reporting system plays in strengthening the financial sector for an accelerated private sector growth could be viewed in diverse ways-policy wise, operational wise and challenges.

### **2.1 Policy Considerations**

Starting on the policy front, the outlook in Ghana for the better part of the last two decades has been to achieve a private sector led economic growth. This vision is faced

with diverse inhibitions, key among which is access to and affordable credit for the private sector. For the greater part of Ghana's credit history, the private sector has been consistently crowded out due to a cocktail of reasons some of which were excessive Government borrowing leading to high short term interest rates, inflationary pressures, lack of collateral and other credit requirements. These high lending rates have resulted in a high default rate among the few who managed to access credit creating a high perception of risk in lending to the private sector.

Over the last few years however, significant improvements in macroeconomic management have resulted in improved levels of macro-stability, substantially reduced Government borrowing, declining short term interest rates and rate of inflation. These have succeeded in lowering lending rates significantly making credit more affordable than in previous years. In addition to these developments, the increasing number of Banks in Ghana has also intensified the level of competition in the financial sector, giving the private sector several alternatives and avenues for shopping for credit.

Unfortunately, lending rates have failed to trend further downwards as expected, due to the fact that financial institutions most of whom are still saddled with huge non-performing loan portfolios, perceive the private sector as a high risk zone. Additionally, the existing high risk has attracted premium costs to risk in overall credit delivery thereby making credit pricing insensitive to falling rates in the economy. These large portfolios of non performing loans have been attributed to information asymmetries between lenders and borrowers, leading to adverse selection and consequently moral hazard. Thus, any attempt at mitigating the problem of lack of access to and affordable credit for the private sector must be in tandem with addressing these concerns of credit providers, hence the essence of a credit reporting system.

## **2.2 Operational Issues**

Credit reporting systems decrease or eliminate information asymmetries between lenders and borrowers that normally lead to adverse selection and consequently a high default rate in loan repayments. Credit Referencing Agencies collate credit information from credit providers, process and store this data, and develop them into a credit rating or scoring on the borrowers involved. Thus any credit provider approached for credit will now be able to check on the credit history of the prospective borrower, and thereby ascertaining the borrower's credibility or credit worthiness. This means that the previous practice of a borrower owing Bank A extensively and hopping to Bank B for a loan, without any means whatsoever of checking on his background would now be effectively mitigated, eliminating the usual information asymmetries that have adversely affected the credit system to date. There are operational attributes to both creditors and borrowers such as

- Credit scoring system will allow credit providers to more accurately evaluate the level of risk involved in lending to a particular borrower thereby improving portfolio quality. This will result in lower risk premiums on loans thereby reducing the cost of credit to borrowers. Eventually scientific credit pricing based

on customer risk profiles would have been established including competitive pricing regimes with its attendant benefit to the private sector. Additionally, ability of credit providers to correctly identify credit worthy clients from the bad nuts eases adverse selection thereby leading to increases in the volume of healthy credit, improvement in access to credit for the well deserving borrowers and the prevention of collective responsibility for both good and bad borrowers in the form of high lending rates across board.

- Allied services offered by Credit Bureaus such as debt collection, restructuring and management also takes the burden of debt recovery off credit providers. Debt restructuring and management also offers debtors alternative arrangements to servicing their debts which have not been previously offered by credit providers.
- One very interesting dimension to the existence of a credit reporting system is the need to create a unique identifier impossible to duplicate to ensure that credit information belongs to the rightful person as well as facilitate easy processing of large databases. This could be in the form of a
  - National Identification card number,
  - IRS tax PIN number,
  - Social Security Number or a
  - National Health Insurance Number.

The National Identification Project must therefore be expedited to facilitate a more efficient credit bureau system of operation as explained above. Other forms of identification like IRS Tax Pin Number, and Social Security Number especially for MSMEs will have the knock on effect of ensuring that the private sector updates its records with the IRS and SSNIT to bring their files and payments up to date as required. These development altogether would improve record keeping, bring sanity, transparency and efficiency into private sector business operations.

- Furthermore, there would be the need to expand the potential sources of credit information to credit bureaus. Credit information from Banks is most likely to cover mainstream borrowers who normally have collaterals and other requirements to access credit from Banks and not MSME/Informal Sector who form the largest proportion of Ghana's private sector and are the main target of such legislative reform. It is therefore imperative that sources of data/credit information would have to be broadened after sometime to include utility providers – power, telephone, water, business – trade credit firms who deal with these MSMEs, consumer credit/hire purchase companies, debt collection agencies, commercial court records, SSNIT- social security payment records of private sector firms for their Staff and Internal Revenue Service (IRS) - record of P.A.Y.E. payments for Staff.

- Additionally, expanding potential sources of credit information to include other sources listed above would have several positive effects within Ghana's economy such as
  - Contributing immensely to tireless efforts by SSNIT to get the informal sector and recalcitrant employers to pay up their Social Security contributions for their Staff.
  - Similarly, IRS P.A.Y.E and corporate tax records being used as a criterion to ascertain risk of lending to MSMEs will help Government achieve its longstanding objective of widening the tax net and roping in the informal sector to increase Government tax revenue.
  - Additionally, the use of trade credit reputation and records (e.g. hire purchase, consumer credit) would also bring sanity into repayment attitudes of the private sector.

Another sensitive dimension is the kind of information that should be passed on to Credit Bureaus. In most African countries in the process of legislative reform on credit bureaus, this has been a hot spot for debate. Much as there is general consensus on passing on negative information without the permission of the client, people develop cold feet as to whether they would like their positive information passed on.

- Furthermore, another useful side of credit referencing system is the ability of first time borrowers to more easily access credit, especially when sources of credit information are broadened to include suggestions made above. First time borrowers could use their positive records on other monthly financial payments to build a credit rating which could be used by lenders to invariably ascertain the level of risk involved in lending to these first time borrowers. This could alleviate the existing barriers to access to finance for first time borrowers mostly as a result of not being known and the unavailability of historic data to adequately appraise them financially.

### **2.3 Challenges**

There are however strong challenges to be addressed.

- First of all, the lack of a National identification System and the absence of a street address system in Ghana makes it difficult to have a valid basis of identification to facilitate easy processing of data without mixing up identities and addresses.
- Utility providers are not adequately automated and records are not up to date to facilitate timely submissions of client records to credit bureaus.
- IRS and SSNIT records would have to be accurate and up to date to enable its use as a means of credit scoring and rating for first time borrowers.
- The essence of this is that the attitude of the private sector to these monthly regulatory/mandatory financial commitments is likely to be an acceptable proxy for their attitude to any other monthly financial commitments and therefore serve

as basis for a good estimation of the level of risk involved in lending to them To authenticate the provision of data from these additional sources, a clear provision must be made in the law mandating these institutions to pass on defaults in payment to credit bureaus to facilitate effective assessment of credit risk in lending to the private sector.

- Lastly, the public is less informed as to the exact nature of credit referencing bureaus and the consequent effect of the operations on their economic lives. Going forward there would be the need to embark on an aggressive public awareness programme to ensure that the public is ready for this and well apprised of its benefits.

### **3. Conclusion**

In conclusion the Credit Referencing System once implemented would eliminate information asymmetries between lenders and borrowers, allow for scientific risk profiling that will help reduce the rather high level of risk premium on credit to the private sector and ultimately reduce the cost of credit. Additionally, it will enhance access to credit for the private sector with the potential to positively impact on economic growth through increased output, employment generation and income growth, and in effect reduce poverty. However this would not be without challenges as outline above.

An efficient Credit Referencing System would contribute immensely to the Government's avowed aim of making the private sector the engine of growth and also assist in the realisation of becoming a middle income country by the year 2015.

**Author: Emmanuel Owusu-Sekyere,**

**Technical Officer-Capital Markets/EMCB-FSR  
Financial Sector Division  
Ministry of Finance and Economic Planning**

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